Nos. 12959, 12970, 12971.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 12959.

C. ABBOTT LINDSEY and PAULINE LINDSEY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 12970.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ELEANORE LANGER,

Respondent.

No. 12971.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF R. L. LANGER, Deceased; ELEANORE LANGER, Executrix,

Respondent.

BRIEF FOR PETITIONERS LINDSEY AND RESPONDENT LANGER.

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ESTATE OF R. L. LANGER, Deceased; ELEANORE LANGER, Executrix,

Respondent.

BRIEF FOR PETITIONERS LINDSEY AND RESPONDENT LANGER.

Jurisdiction.

These petitions for review involve federal income taxes of C. Abbott Lindsey and Pauline Lindsey, husband and wife, for the calendar years 1944 and 1945, and Eleanore

Langer and the Estate of R. L. Langer, deceased, Eleanore Langer, executrix, for the calendar year 1944.

The Commissioner of Internal Revenue in 1947 and 1948 determined deficiencies in the federal income taxes of each of the taxpayers, and mailed notices of deficiency [R. 8-9, 32, 33, Docket Number 12959; R. 10-11, Docket Number 12970; R. 10-11, Docket Number 12971]. The taxpayers thereafter filed petitions with the The Tax Court of the United States (herein referred to as the "Tax Court") pursuant to the provisions of Section 272 of the Internal Revenue Code (26 U. S. C. A., Sec. 272). The original decisions of the Tax Court were in favor of the Commissioner of Internal Revenue (13 T. C. 419). Following appeal of said decisions to this Court, and reversal thereof and remand to the Tax Court, the decisions of the Tax Court on remand were entered April 3, 1951 [R. 64-65, Docket Number 12959; R. 30, Docket Number 12970; R. 30, Docket Number 12971].

Petition for review was filed by C. Abbott Lindsey and Pauline Lindsey on or about May 2, 1951 [R. 66-68, Docket Number 12959] pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code (26 U. S. C. A., Secs. 1141 and 1142). Petitions for review in the *Langer* cases were filed by the Commissioner of Internal Revenue on or about May 3, 1951 [R. 31-32, Docket Number 12970; R. 31-32, Docket Number 12971] pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code (26 U. S. C. A., Secs. 1141 and 1142).

Previous Opinions.

The following opinions have heretofore been rendered in these causes:

Original opinion of the Tax Court reported at 13 T. C. 419.

The opinion of this Court on appeal from said original decisions of the Tax Court, reported at 183 F. 2d 758.

The opinion of the Tax Court on remand reported at 16 T. C. ......, No. 6 [R. 49-63, Docket Number 12959; R. 15-29, Docket Number 12970; R. 15-29, Docket Number 12971].

Question Presented.

The single question presented for adjudication in these proceedings is whether back pay received by the taxpayers in 1944 and 1945 exceeded 15% of their gross income for said years as that term is used in Section 107(d) of the Internal Revenue Code (26 U. S. C. A., Sec. 107(d)).

Statute and Regulations Involved.

Section 107(d) of the Internal Revenue Code (26 U. S. C. A., Sec. 107(d)), and regulations issued pursuant thereto are set forth in the Appendix, *infra.*

Statement.

During the calendar year 1944 C. Abbott Lindsey, as an officer and employee of Commodore Hotel Co., Ltd., a California corporation (herein referred to as "Commodore"), received back pay of $10,000 from Commodore, allocable $5,000 to C. Abbott Lindsey and $5,000 to

Pauline Lindsey, they having filed separate returns for said year on a community property basis [R. 56-57, Docket Number 12959]. In 1945 Lindsey, as an officer and employee of Commodore, received back pay of $11,-500 from Commodore, allocable $5,750 to C. Abbott Lindsey and $5,750 to Pauline Lindsey, they having filed separate returns for said year on a community property basis [R. 57, Docket Number 12959].

During the calendar year 1944, R. L. Langer, as an officer and employee of Commodore, received back pay of $10,000 from Commodore, allocable $5,000 to R. L. Langer and $5,000 to Eleanore Langer, they having filed separate returns on a community property basis for said year [R. 22, Docket Number 12970; R. 22, Docket Number 12971]. (The Langers also received back pay in 1945, but said year is not before the Court.)

Both the Langers and the Lindseys computed their tax liabilities for the years involved under the provisions of Section 107(d) of the Internal Revenue Code. In so doing they applied to the back pay the rates of tax applicable for the years to which said back pay was allocable. The Commissioner of Internal Revenue audited the Langer returns for the year 1944 and the Lindsey returns for the years 1944 and 1945 and determined that none of them were entitled to apply Section 107(d), stating as reasons therefor that:

(1) Commodore's failure to pay the salaries during the prior years was not attributable to the existence of a condition similar to bankruptcy or receivership;

(2) There was no continuing obligation in the prior years to pay the salaries; and

(3) The back pay did not constitute 15% or more of gross income of the taxpayers for the years 1944 and 1945.

Upon the trial of the cases (which were consolidated in the Tax Court) the Tax Court concluded that the conditions affecting Commodore in the prior years were not similar to bankruptcy or receivership and that, consequently, Section 107(d) could not be availed of by any of the taxpayers. Having so concluded, the Tax Court made no findings on the other two issues.

This decision of the Tax Court was appealed by the taxpayers to this Court. Upon review of the matter, this Court reversed the decision of the Tax Court and remanded the cases for findings upon the other two issues. (*Estate of R. L. Langer, deceased, Eleanore Langer, executrix, et al. v. Commissioner of Internal Revenue,* 183 F. 2d 758.)

Upon remand, the Tax Court considered the two remaining issues and decided as follows:

(1) That there was a continuing legal obligation requiring Commodore to pay the salaries for the prior years;

(2) That the back pay received by the Langers in 1944 was more than 15% of their gross incomes for said year; and

(3) That the back pay received by the Lindseys in 1944 and 1945 was, in both years, less than 15% of their gross incomes [R. 49-63, Docket Number 12959; R. 15-29, Docket Number 12970; R. 15-29, Docket Number 12971].

In accordance with said findings and conclusions, the Tax Court entered decisions of overpayments by the Langers for the year 1944, and of deficiencies for the Lindseys for both 1944 and 1945 [R. 64-65, Docket Number 12959; R. 30, Docket Number 12970; R. 30, Docket Number 12971].

Thereafter petitions for review were filed by the Lindseys in their cases, and by the Commissioner of Internal Revenue in the *Langer* cases [R. 66-68, Docket Number 12959; R. 31-32, Docket Number 12970; R. 31-32, Docket Number 12971].

In the *Langer* cases the Tax Court found that the Langers were members of two joint ventures, one relating to the Clifton Hotel, in Los Angeles, and the other relating to the Figueroa Hotel, in Los Angeles. It further found that only the distributive shares of the Langers in the net profits of said joint ventures were includible in the Langers' gross income; and that, on the basis of these figures, the back pay received by the Langers in 1944 exceeded 15% of their total gross income. Decisions were entered in favor of the Langers [R. 15-29, Docket Number 12970; R. 15-29, Docket Number 12971].

C. Abbott Lindsey during the years 1944 and 1945 operated, as a sole proprietorship, a cafe at the Commodore Hotel. He and Mrs. Lindsey reported in Schedule "C" on page two (or three) of their Federal income tax returns the gross receipts and net profits realized from the operation of said cafe. They carried forward to page one of their returns for both years, and included as "income from other sources" at line four, the profit realized from the cafe operation. The back pay received by the Lindseys in 1944 and 1945 exceeded 15% of their "gross income" as shown on the face or page one of their returns. How-

ever, the Tax Court found that their "gross income" should be computed by taking into account not only the income from the cafe business carried forward by the Lindseys to and appearing on the first page of their returns, but also items deducted from the gross receipts of the cafe on Schedule "C" of their returns. These other business deductions amounted to $57,385.88 in the year 1944 and $65,564.72 in the year 1945. The Tax Court found that the gross income of the Lindseys for both years must include, so far as the cafe operation was concerned, the gross receipts from the cafe less only the amounts designated on Schedule "C" as "cost of goods sold." The cost of goods sold represented only inventory of food used in the cafe operations [R. 49-63, Docket No. 12959].

Having so expanded the Lindseys' "gross income", the Tax Court found that the back pay received by them was less than 15% of gross income. Accordingly, the application of Section 107(d) of the Internal Revenue Code was denied. The Tax Court entered judgments of deficiency in favor of the Commissioner of Internal Revenue [R. 64-65, Docket No. 12959]. The Lindseys in due course filed petitions for review of the decisions in their cases. The Commissioner of Internal Revenue filed petitions for review in the *Langer* cases.

Specification of Errors.

(1) The Tax Court erred in its conclusion that, for purposes of determining the application of Section 107(d) of the Internal Revenue Code, there must be included in the Lindseys' gross income anything more than the net profit from the operation of the cafe at the Commodore Hotel, which figure was brought forward from Schedule "C" of their respective returns to the first page thereof.

(2) The Tax Court erred in failing to find that the Lindseys have overpaid their federal income taxes for the calendar years 1944 and 1945.

Summary of Argument.

The term "gross income" is not defined in Section 107(d) of the Internal Revenue Code. The term has been given varying definitions depending upon the circumstances involved in particular cases and the statutory objectives under consideration.

The meaning of the term "gross income" as used in Section 107(d) must be ascertained in relation to the objectives of said section of the Code. The statutory purpose underlying Section 107(d) must be given great weight in the application of the statute to the facts involved in these or any other cases. The statute is remedial and should be interpreted so as to accomplish its remedial objective without discriminating between the taxpayers who were intended to be benefited.

The construction placed upon the statute by the Tax Court in the *Lindsey* cases frustrates the legislative purpose, and creates distinctions and discrimination where no such purposes can reasonably be attributed to the Congress.

Outline of Argument.

A. The term "gross income" is not defined in Section 107(d) of the Internal Revenue Code. Because it is not a term of uniform definition in the Internal Revenue Code, it is proper for this Court to determine its meaning as used in Section 107(d).

B. As used in Section 107(d) of the Internal Revenue Code, gross income means the sum of the income items appearing on page one of the taxpayer's return.

ARGUMENT.

A. The Term "Gross Income" Is Not Defined in Section 107(d) of the Internal Revenue Code. Because It Is Not a Term of Uniform Definition in the Internal Revenue Code, It Is Proper for This Court to Determine Its Meaning as Used in Section 107(d).

The question presented on these petitions for review is whether the amount of the back pay received by the taxpayers during the taxable years exceeds 15% of their respective gross incomes for such years. The Tax Court held that, in the case of the Langers, the back pay did exceed 15%; but that in the case of the Lindseys, it did not. The stated basis for distinction was that, though both the Langers and the Lindseys received income from business operations, that which was received by the Langers represented their shares of the net profits of joint ventures of which they were members, whereas that of the Lindseys was derived from a sole proprietorship operation.

Neither Section 107(d) nor the regulations promulgated thereunder defines the term "gross income" as used in the section. Section 22(a) of the Internal Revenue Code states that gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal services, or from professions, vocations, trades, businesses, commerce, or sales or dealings in property, etc. Precisely what amount is to be included in the gains, profits, and income of an individual from business is not specified in Section 22(a) or elsewhere in the Internal Revenue Code.

Nevertheless, the Courts have been called upon in many cases other than the present ones to determine what is

gross income. What is gross income for purposes of one section of the Internal Revenue Code is not necessarily gross income for all purposes. This is well illustrated by the case of *Woodside Acres, Inc. v. Commissioner of Internal Revenue* (C. C. A. 2d, 1943), 134 F. 2d 793. The question before the court in that case was whether the petitioner was a personal holding company within the meaning of Section 352(a)(1) of the Revenue Act of 1936, as amended. The petitioner, a corporation, owned assets consisting of securities and a dairy farm. For the calender year 1937 it received as income $67,212.08 from dividends, interest, and rents (personal holding company income). It reported that amount, together with gross receipts from the operation of its dairy farm in the amount of $24,663.09. From its gross farm receipts, concerning which there was no dispute, it deducted only two small items, consisting of the cost of milk and cream purchased for resale and sold, and amounts paid for seed and plants. Its gross farm income, so computed, was $22,606.31. If that amount was the correct amount of its gross income from the dairy, the petitioner was not subject to the personal holding company surtax, because its personal holding company income was not 80% or more of "gross income."

The Commissioner, however, took the position that other items, consisting of the cost of feed used in the operation of the dairy farm and the cost of dairy labor, should have been deducted from gross receipts to arrive at the gross farm income. If either of said items (each amounting to approximately $5,000) should have been deducted from gross farm receipts, the petitioner would have been a personal holding company, and subject to the personal holding company surtax, because its income from securities would have exceeded 80% of its gross income.

The petitioner argued that the Commissioner's regulations, Article 22(a)-7 of Regulations 94 (the regulations in effect under the 1936 Revenue Act) dealing with the gross income and expenses of farmers, directed farmers to include in gross income their gross receipts; and that, therefore, the same interpretation of gross farm income should be applicable for purposes of the personal holding company surtax.

The Court of Appeals for the Second Circuit disagreed with the taxpayer, stating that:

> "This argument is indeed plausible but there are good reasons why it misses the mark. The regulations are perfectly clear and reasonable interpretations of the statutes they were originally drawn to interpret. And they continued to have the same virtue in respect to the 1937 Act so far as they were applicable. It is only necessary to confine their application to the subject they were designed to cover, *i. e.,* the computation of the taxable income of farmers. They were originally promulgated when it did not make any difference taxwise whether a corporation which was a farmer as defined in the regulations might derive all its income from farming or part in that way and part from securities in whatever proportion. It did not matter whether some subtraction was made from gross receipts to get what was called gross income from which other allowable deductions were made to arrive at net taxable income or whether the order of deduction was different and the amount of what was called gross income consequently different so long as net taxable income was the same. But when the taxation of personal holding companies as such began and what were such companies was made in part to depend upon the nature of the source of a given percentage of their gross income, it became

necessary in order to determine who was liable for such surtaxes, to make precise computations of gross income. No less was required by the need for classification of the taxpayer as, or as not, a personal holding company with the nature of the source of its gross income one of the factors to be given effect. Then regulations which were plainly promulgated to make it easy for farmers to report their farm income for taxation and still served that purpose were surely left to provide the same assistance to taxpayers and tax collectors. But they were not necessarily also extended to a situation as to which they were inadequate. Congress did not expressly do that when it provided that the terms used in Title IA should mean what the same terms meant when used in Title I. Farmers might still compute their net taxable income as the regulations did, and had, provided. Yet gross income so determined for that purpose did not become an immutable factor in determining whether a corporation which ran a farm was also a personal holding company. Congress made no mention of any regulations. *We are unwilling, therefore, to impute to it an intent to adopt apparently inapplicable regulations which define gross income for one purpose to provide the definition of gross income for the entirely new and different purpose of the personal holding company taxing statute.*" (Emphasis added.)

Here is explicit recognition that the term "gross income" may have different meanings depending upon the context in which it appears.

A further example is *Grange Trust v. Commissioner,* Tax Court Docket No. 111169, decided April 17, 1945 (Commerce Clearing House dec. 14,517(M), 4 T. C. M. 400; 1945 Prentice-Hall T. C. Memorandum Decisions,

page 451). Therein one of the questions involved was what constitutes gross income for purposes of Section 275(c) of the Internal Revenue Code (relating to the five year statute of limitations on assessment of deficiencies where amounts omitted from gross income exceed 25% of the taxpayer's gross income). The taxpayer in said case, in its fiduciary returns, reported on Schedule B rentals in the aggregate amount received; and the taxpayer deducted therefrom depreciation, repairs, taxes, expenses, and the like. The difference was entered on the face of the return. The Commissioner of Internal Revenue claimed in said case that there was an omission from gross income in excess of 25% in that gross receipts from rentals were not disclosed on the face of the return. The Tax Court rejected the Commissioner's contention and held that there had not been an omission in excess of 25%, thereby ruling that the five-year statute of limitations was not applicable. The Tax Court said, in its opinion:

> "In the two fiduciary returns filed by the trust—one for Grange Farm and one for Grange Development—rents in the aggregate amount of $54,698.74 were reported in Schedule B, and depreciation, repairs, taxes, expenses, etc., were deducted. There was entered on the face of the return the difference, an aggregate amount of $33,388.82. The respondent spells out of this an omission from gross income of $25,872.30 ($54,698.74—$33,388.82+$4,563.38), which, of course, is in excess of 25 per centum of the amount stated on the face of the return.

> "Petitioner does not agree with respondent's analysis of the facts nor do we. The form was filled out in accordance with the instructions. Obviously the responsible officers of the Treasury Department, who prepared the form, had in mind that the schedule should show the actual rentals received and the legal deductions and that there should be brought onto the face of the return only the true income resulting. *This, together with interest, capital gains, dividends, Net Profit (or Loss) from Trade or Business, and other income constituted the gross income of the trust."* (Emphasis added.)

We thus have one case where "gross income" was held to mean one thing for the purposes of the personal holding company surtax and another case in which an entirely different meaning was imputed to the identical term where the statute of limitations was involved.

In the present cases it is entirely proper for the Court to examine the statute, ascertain its objectives, and apply its terms in the light of those objectives. The definition of gross income in Section 29.22(a)-5 of Regulations 111 is not applicable here. That section is concerned with gross income from manufacturing, merchandising, and mining. Its purpose is to define, as to such businesses, the Constitutional limits within which the income tax laws may operate. It contains no reference to Section 107(d) of the Internal Revenue Code; and has no necessary connection with it, or the relief it was designed to afford.

B. As Used in Section 107(d) of the Internal Revenue Code, Gross Income Means the Sum of the Income Items Appearing on Page One of the Taxpayer's Return.

Section 107(d) of the Internal Revenue Code is a relief provision. It provides, in effect, that if a salary earner does not, for specified reasons beyond his control, receive his compensation in the year in which he rendered services, but later receives that compensation, he shall not be required to pay income tax on such compensation in the year of receipt in an amount greater than he would have had to pay had he received the compensation in the earlier years to which the compensation is applicable. The section permits the computation of tax on such receipts at rates, and upon a basis, different from that otherwise prescribed. It is not an exemption provision, because it does not permit the exclusion of any amounts received from gross income. It is, however, a relief provision, which must be liberally construed to effectuate the objectives sought by the legislature. Mertens, *Law of Federal Income Taxation,* Volume 1, page 71; *Keeble v. Commissioner,* 2 T. C. 1249 (1943).

In the *Keeble* case, *supra,* the Tax Court was called upon to interpret Section 107(a) of the Internal Revenue Code (26 U. S. C. A., Section 107(a)). The Commissioner contended, in that case, that Section 107(a) was a provision granting an exemption from tax and that it should, therefore, be strictly construed. The Tax Court rejected this argument, saying in part:

> "The statute is remedial, granting relief to those coming within its terms. A remedial statute should be given a rational, sensible construction and one which will 'give the relief it was intended to pro-

vide.' *Bonwit Teller & Co. v. United States,* 283 U. S. 258; *F. Harold Johnston, Executor,* 33 BTA 551; *Michel J. A. Bertin,* 1 TC 355. 'Common sense interpretation is the safest rule to follow in the administration of income tax laws,' *Rhodes v. Commissioner,* 100 F. (2d) 966; and 'a desire for equality among taxpayers is to be attributed to Congress, rather than the reverse,' *Colgate-Palmolive-Peet Co.,* 320 U. S. 422."

Since it is apparent from reading them that all of the subsections of Section 107 of the Internal Revenue Code are directed toward the same objective, they should all be given the same sensible construction.

Examination of the legislative history of Section 107(d) reveals the Congressional intent that the section should not be restricted to the extent sought by the Commissioner. The provision first appeared as Section 113 of the House version of the Revenue Bill of 1943. In its original form it would have applied only to back pay received by an individual arising out of:

(1) Any alleged unfair labor practice of an employer under the National Labor Relations Act;

(2) Any alleged violation of Sections 6 or 7 of the Fair Labor Standards Act of 1938; or

(3) Any retroactive wage increase provided for by the National War Labor Board.

In other words, the House version covered only wage adjustments of the type described in Section 107(d)(2)(B) of the Statute as finally enacted.

The House proposal was eliminated by the Senate Finance Committee, with the following explanation (Senate Report No. 627, 78th Cong., 1st Sess.):

> "The House adopted a provision relating to the taxes on back pay received by an individual for services rendered in a prior year because of alleged unfair labor practice under the National Labor Relations Act, or a violation of the Fair Labor Standards Act, or a retroactive increase approved by the National War Labor Board. Your committee was unable to agree with this provision *because of its limited application* and it has, therefore, been omitted from the bill." (Emphasis added.)

Section 107(d) in its present form was added to the Revenue Act of 1943 by the Conference Committee (Amendment No. 30). The statement of the Conference Committee described the provisions of the section as agreed upon in committee. With respect to the 15% limitation, only the following statement was made:

> "The new subsection provides that if the amount of such back pay exceeds 15 percent of the gross income of the individual for the taxable year, the part of the tax for such year which is attributable to the inclusion of the back pay in gross income shall not exceed the sum of the increases in the taxes which would result from the inclusion of the respective portions of the back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the Commissioner with the approval of the Secretary."

It is significant that the Senate rejected the House version, which was of narrow application. The benefits of the relief provision as ultimately enacted were intended to

cover not only wage earners, but salary earners, professional men, business men, and the like. The only apparent explanation for the 15% limitation was to restrict the relief to those cases in which the amount of back pay is a significant factor in the computation of the *tax liability* of the individual. From the standpoint of the individual, the income brought forward to the face of his return, which is used by him as the starting point for the actual computation of his tax liability, is the significant figure, and the one which should logically be considered in applying the 15% rule.

Such must have been the intent of Congress when it enacted Section 107(d). As has already been stated herein, that code provision was added by the Revenue Act of 1943. The 1943 Act was first passed by Congress in the early part of February, 1944. It was vetoed on February 19, 1944, and became law on February 25, 1944, after passage over the veto.

At the time it was considering the Act, Congress had before it the method of reporting which had been in effect for many years prior to 1944, and which was in effect during the years involved in the *Grange Trust* case, *supra.* Such method involved bringing forward to the face of the return, among other items, net profit from a trade or business. It must have had in mind that the total of such income items would constitute the "gross income" to which the 15% limitation would be applied. Such a definition was adopted by the Tax Court in the *Grange Trust* case, *supra,* and is just as appropriate here; in fact, is the only definition which will result in a reasonable application of the law. True, that case involved rents whereas this one involves business income, but there is no difference between net rents and net business income.

The 1944 and 1945 individual federal income tax returns, Form 1040, showed, on page 1 (the front page of the return) first a space for listing the taxpayer and other persons for whom exemptions are allowable. At line 2 of page 1 of the return, space is provided for entering the taxpayer's total wages, salaries, etc. At line 3 there is a space for reporting dividends and interest, with the following notation:

> "3. Enter here the total amount of your dividends and interest (including interest from Government obligations unless wholly exempt from taxation)."

At line 4 there is a space provided for other income, with the following notation:

> "4. If you received any other income, *give details on page 3* (page 2 of the 1945 form) and enter the total here." (Emphasis added.)

At line 5 the taxpayer is instructed to "Add amounts in items 2, 3, and 4, and enter the total here." Lines 2, 3, and 4 of page 1 of the individual return are bracketed, and opposite the bracket there is the statement in heavy type "your income."

On page 3 of the return form (page 2 in the 1945 form) there are schedules headed as follows:

Schedule A—Income from annuities or pensions.

Schedule B—Income from rents and royalties.

Schedule C—Profit (or Loss) from Business or Profession.

Schedule D—Gains and losses from sales or exchanges of capital assets, etc.

Schedule E—Income from partnerships, estates, and trusts, and other sources.

At the bottom of said schedules there appears in heavy type the following language:

> "Total income from above sources (enter as item 4, page 1)."

It is interesting to note that Schedule C does not use the term "gross income." The terminology used is "total receipts" (line 1); "gross profit" (line 10); and "net profit" (line 22).

The returns of the Lindseys and the Langers were prepared on Forms 1040 in accordance with the instructions laid down by the Commissioner of Internal Revenue. The details of business and income from joint ventures were disclosed by the taxpayers on page 2 (or 3, as the case may be) of their respective returns. They then carried forward to page 1 of their returns, at line 4, the income so detailed. This was not only required by the form but also determined the amount of gross income which these individuals received for purposes of Section 107(d).

The case of *Grange Trust v. Commissioner* has already been referred to in this brief, *supra.* The Tax Court stated, in that case that true income from rents was actual rentals received less legal deductions; and that "this, together with interest, capital gains, dividends, Net Profit (Or Loss) from Trade or Business, and other income constituted the gross income * * *." Certainly the method of reporting income prescribed by the Commissioner of Internal Revenue would lead to the conclusion that the applicability of a relief provision such as Section 107(d) is to be determined in relation to the income appearing on the first page of the individual return.

The function of Section 107 of the Internal Revenue Code is to ease the tax *burden* of described taxpayers.

That burden is measured by rates applied to net taxable income. In the enactment of Section 107(d) Congress adhered to its purpose of alleviating the tax burden in special circumstances by extending the relief provision to cover back pay. The section was to be applicable to the individual only if the tax for the year in which back pay is received (based on net income) is heavier without computing the tax under the special method prescribed.

When the additional requirement that the back pay be more than 15 per cent of gross income was inserted, Congress likewise must have been thinking in terms of the tax burden. Therefore, the gross income of which the statute speaks must be the amount of income shown on page one of the tax return, from which allowable deductions, such as contributions, taxes, medical expenses, and the like, are subtracted to arrive at net income. Congress must have thought that when the back pay exceeds 15 per cent of that gross income figure the tax burden resulting from the receipt in the taxable year of the back pay is sufficient to warrant relief. So read, the statute effectuates the legislative purpose to afford relief where an undue burden of tax would otherwise have to be shouldered; and a rational, sensible result is accomplished.

An absurd purpose and an irrational result are ascribed to the legislature by the Commissioner. Suppose, for example, that an individual operating a proprietorship business has total receipts for a taxable year of $1,000,000, cost of goods sold of $750,000 and other business deductions of $250,000. He has realized no profit from his business operation. Further assume that he received back pay during the taxable year in the amount of $35,000, attributable to several prior years, and that he has no income from other sources. Under the Commissioner's

view, even though the only figure appearing on the face of the individual's return is the $35,000 of back pay, he would not be entitled to apply Section 107(d) because the back pay would be less than 15% of "gross income" as the term is interpreted by the Commissioner. Yet here is an individual who would seem to be as deserving of the relief of the section as, for example, the taxpayer involved in the case of *Kenny v. Commissioner*, 4 T. C. 750 (1945), which decision is discussed at length in this Court's opinion on the first appeal of the instant cases.

The Tax Court called attention to the fact that the statute speaks of "gross income" rather than "adjusted gross income." The concept of adjusted gross income was not in the Internal Revenue Code when Section 107(d) was enacted, but came later when Section 22(n) was added to the Code by the individual Income Tax Act of 1944.

Furthermore, petitioners do not make any contention that "adjusted gross income," as such, is the item to which the 15% is to be applied. It is submitted, merely, that "gross income," for the purpose of Section 107(d), should be defined as hereinabove set forth.

The decisions of the Tax Court in these cases illustrate the anomalous consequences of the interpretation sought by the Commissioner. Both Langer and Lindsey received equal amounts of back pay during the years involved. Each of them had income from other business operations. As a result of what might be called the purely fortuitous circumstance in the *Langer* case of that business income being from joint ventures, instead of proprietorships, the Tax Court decided in favor of the Langers. The percentage of the income appearing on page one of the Lindsey returns represented by back pay was sub-

stantially greater than that of the Langers; and it would seem only logical that their right to relief should be the same as that of the Langers. Yet as a consequence of what is believed to be a purely technical difference, the Lindseys have been denied relief. If the United States Supreme Court was correct in saying, in *Colgate-Palmolive-Peet Company v. United States,* 320 U. S. 422, 64 S. Ct. 227 (1943), that "a desire for equality among taxpayers is to be attributed to Congress, rather than the reverse," then it is submitted that the decisions of the Tax Court below should have been in favor of the Lindseys as well as the Langers.

Respectfully submitted,

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September 5, 1951.

APPENDIX.

Section 107, Internal Revenue Code.

Sec. 107. Compensation for Services Rendered for a Period of Thirty-six Months or More and Back Pay.

(d) Back Pay—

(1) In General—If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 per centum of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under the regulations prescribed by the Commissioner with the approval of the Secretary.

(2) Definition of Back Pay—For the purposes of this subsection, "back pay" means (A) remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year except for the intervention of one of the following events: (i) bankruptcy or receivership of the employer; (ii) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (iii)

if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (iv) any other event determined to be similar in nature under regulations prescribed by the Commissioner with the approval of the Secretary; and (B) wages or salaries which are received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period prior to the taxable year; and (C) payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal Law relating to labor standards or practices, and which are determined under regulations prescribed by the Commissioner with the approval of the Secretary to be attributable to a prior taxable year. Amounts not includible in gross income under this chapter shall not constitute "back pay."

Regulations 111.

Reg. 111, Sec. 29.107-3. Back pay attributable to prior taxable years. Section 107(d)(2) defines "back pay" and Section 107(d)(1) limits the amount of tax resulting from the inclusion of such back pay in gross income for the year in which it is received or accrued. Back pay includes compensation, wages, salaries, pensions and retirement pay received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the following events: (1) bankruptcy or receivership of the employer; (2) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (3) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrurmentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (4) any other event determined to be similar in nature under these regulations. As to what constitutes bankruptcy and receivership proceedings see Section 29.274-1.

An event will be considered similar in nature to those events specified in Section 107(d)(2)(A)(i) (ii) and (iii) only if the circumstances are unusual, if they are of the type specified therein, if they operate to defer payment of the remuneration for the services performed, and if payment, except for such circumstances, would have been made prior to the taxable year in which received or accrued. For the purposes of this section the term "back pay" does not include remuneration which is deemed to be constructively received in the taxable year or years

in which the services were performed, remuneration paid in the current year in accordance with the usual practice or custom of the employer even though received in respect of services performed in a prior year or years, additional compensation for past services where there was no prior agreement or legal obligation to pay such additional compensation, or any amount which is not includible in gross income under chapter 1.

The term "back pay" also embraces retroactive wage or salary increases received or accrued in respect of services performed by an employee for his employer in a prior taxable year which have been ordered, recommended, or approved by any Federal or State agency such as, but not limited to, the War Labor Board or any regional War Labor Board, the Salary Stabilization Unit of the Bureau of Internal Revenue, and boards authorized by the Railway Labor Act (44 Stat. 577), as amended (45 U. S. C., 1940 ed., ch. 8), comparable State organizations, and United States and State courts; payments made as a result of alleged violations of Sections 6 and 7 of the Fair Labor Standards Act of 1938 (52 Stat. 1062 and 1063, as amended; 29 U. S. C., 1940 ed., secs. 206 and 207), and made retroactive to any period prior to the taxable year; and payments which are received or accrued during the taxable year arising out of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, such as payments received to effectuate the policies of the National Labor Relations Act (49 Stat. 449), as amended (29 U. S. C., 1940 ed., secs. 151-166). The term "wage or salary increases" as used in this section includes payments not made until after the close of the taxable year on account of regulations, orders or rulings under the Inflation Control Act of 1942 (56

Stat. 765; 50 U. S. C., App., Supp., secs. 961-971) even though the total amount paid for the services rendered does not exceed the amount payable by contract or under established policy.

An individual must compute his net income for any taxable year to which back pay is attributable, even though he was not required to make a return for such year. Thus, all amounts properly includible as gross income for any taxable year to which back pay is attributable must be included in the computation.

For the purpose of determining under Section 107(d) the particular taxable year or years to which the back pay is attributable and, if such back pay is attributable to more than one taxable year, the amount thereof which is attributable to each of such taxable years, the following rules will be applicable:

(1) Back pay, as defined under Section 107(d)(2)(A), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year except for the intervention of one of the events described in Section 107(d)(2)(A).

(2) Back pay, as defined under Section 107(d)(2)(B), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it would have been paid in such year had the wage or salary increase as described in Section 107(d)(2)(B) been actually put into effect on the date to which it was first made retroactive.

(3) Back pay, as defined under Section 107(d)(2)(C), shall be deemed to be attributable to a particular taxable year in the amount and to the extent that it represents payments in respect of the alleged violation described in

Section 107(d)(2)(C) which occurred in such year or which continued during any part of such year.

(4) In those cases where a computation has been made by, or under the direction of, a Federal or State agency (including any Federal or State court) under which the back pay was awarded, which indicates that particular portions of such back pay are attributable to certain definite periods of time, such computation shall be accepted as the appropriate apportionment for the purposes of these regulations.

(5) Where no such computation has been made as provided in (4), and where the apportionment cannot be accurately made upon consideration of all the attendant circumstances in accordance with the applicable rule prescribed in (1) (2) or (3), then in proper cases the back pay shall be apportioned to each of the taxable years within which fall one or more calendar months included within the entire period for which such back pay has been paid, as if such back pay had been received or accrued in equal portions in each of such calendar months. For the purposes of this section, a fractional part of a month is to be disregarded unless it amounts to more than half a month, in which case it is to be considered as a month.

The first step in determining whether Section 107(d) is applicable is the determination of the percentage which the back pay is of the gross income of the taxpayer for the current taxable year. It must exceed 15 per centum of such gross income. The amount of the tax attributable to such back pay is the difference between the tax for the taxable year computed with the inclusion of such back pay in gross income and the tax for such taxable year computed without including such back pay in such gross income.

The amount of the tax attributable to such back pay in each taxable year is the difference between the tax for such taxable year computed with the inclusion in gross income of the portion of such back pay attributable to such taxable year and the tax for such taxable year computed without including any part of such back pay in gross income.

The tax for the current taxable year is (1) the tax computed with the inclusion in gross income of the entire back pay received or accrued in the taxable year, or (2) the tax computed without including any such back pay in gross income for the current taxable year, plus the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for each taxable year to which each such portion is respectively attributable, whichever is the smaller.

This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1944 and 1941 the alternative tax provided in Supplement T:

EXAMPLE: In 1944 a single person with no dependents who makes his income tax returns on the calendar year basis receives $2,900, which amount constitutes his adjusted gross income. Of this amount $500 constitutes back pay. His tax for the calendar year 1944 on $2,900 would be $490. On $2,400 ($2,900 minus $500) the tax would be $384. That part of the tax for 1944 attributable to back pay is therefore $106 ($490 minus $384). Of the back pay $300 is attributable to the year 1941. During such year he had received $2,000. For such year the

amount of tax on $2,000 is $104. The amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $130. The increase in the tax for such year would be $26 ($130 minus $104).

The remainder of the back pay, $200, is attributable to the calendar year 1940. During such year his net income was $1,800. For such year the amount of tax, including the defense tax, on $1,800 is $36.08 and the amount of tax including the defense tax, which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $44. The increase in the tax for such year would be $7.92 ($44 minus $36.08). The aggregate of increases in the taxes for the calendar years 1941 and 1940 would be $33.92. The tax for the calendar year 1944 is the smaller of $384 plus (1) $106 or (2) $33.92. Since $33.92 is smaller than $106 the tax for the calendar year 1944 is $417.92 ($384 plus $33.92).

Section 6(d)(3) of the Current Tax Payment Act of 1943, as amended by Section 506(b) of the Revenue Act of 1943, provides that Section 107 of the Internal Revenue Code shall be applied without regard to subsections (a) and (b) of Section 6 of the Current Tax Payment Act of 1943. For example, a taxpayer who had received or accrued compensation including back pay in 1943 determines his income tax, including the victory tax, for such year in the manner provided in Section 107 of the Internal Revenue Code before the application of Section 6. In the process of determining such tax, portions of such compensation are attributable to prior years and the limitation upon the increase in the tax for 1943 attributable to such compensation is determined by reference to

the tax for the respective years computed upon the portion of such compensation allocable to such years. While all of such compensation is included in gross income for 1942 or 1943, as the case may be, such compensation is attributable to prior years without regard to Section 6 of the Current Tax Payment Act of 1943. This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1943, 1942 and 1941 the alternative tax provided in Supplement T:

EXAMPLE: In 1943 a single person (not the head of a family) who makes his income tax returns on a calendar year basis receives $2,200. Of this amount $600 constitutes back pay. Including the victory tax, his tax liability for 1943 on $2,200 would be $342.10. On $1,600 ($2,200 minus $600) the tax liability would be $216.60. That part of the tax liability for the calendar year 1943 attributable to back pay is therefore $125.50 ($342.10 minus $216.60). Of the back pay $400 is attributable to the calendar year 1942. During such year he had received $1,000. For the calendar year 1942 the amount of tax liability on $1,000 is $76. The amount of tax liability for such year had he included in gross income the portion of back pay attributable to the calendar year 1942 would be $145. The increase in the tax liability for such year would be $69 ($145 minus $76).

The remainder of back pay, $200, is attributable to the calendar year 1941. During such year he had received $1,000. For such year the amount of tax on $1,000 is $18, and the amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to the year 1941 would be $35. The

increase in the tax for such year would be $17 ($35 minus $18). The aggregate of the increases in the taxes for the calendar years 1942 and 1941 would be $86. The tax liability for the calendar year 1943 is the smaller of $216.60 plus (1) $125.50 or (2) $86. Since $86 is smaller than $125.50, the tax liability for the calendar year 1943, prior to the application of Section 6 of the Current Tax Payment Act of 1943, is $302.60. For the application of Section 6 of the Current Tax Payment Act of 1943, see the regulations thereunder, set forth in Treasury Decision 5300, approved October 1, 1943, and amendments thereto.